Internal Revenue Service
memorandum

date: FEB 19 1991

to: Dennis Driscoll

from: Janine Bosley

subject: [redacted]

You have requested informal technical advice regarding three proposed adjustments arising from [redacted]'s ([redacted]) establishment of a VEBA trust in [redacted] (end of the [redacted] taxable year). These three adjustments arise out of two issues.

The first issue concerns whether $[redacted] (ostensibly creditable to the [redacted]% allowable VEBA safe harbor deduction) of reserves held by an insurance company which are to be returned to the insured are includable in the taxable income of the insured. The determination of this first issue hinges on the discussion of the next issue discussed below.

The second issue relates to the [redacted] and [redacted] taxable year. Exam has questioned whether a deduction is allowable for a $ [redacted] contribution to a VEBA trust in [redacted] and an additional $ [redacted] contribution made in [redacted] for the [redacted] tax year. Exam has taken the position that the deductions should not be allowed because of the limitations contained in I.R.C. §§ 419 and 419A. In considering the technical aspects of this situation the following information is important.

(1) In I.R.C. § 419(b) (effective in 1986), the limitation on the deductibility of contributions clearly specifies that the deductions "shall not exceed" the fund's qualified costs. These costs are then defined as being the "qualified direct costs" and additions, subject to certain limitations, to a "qualified asset account".

(2) In the Committee Reports to the Tax Reform Act of 1986, the following is stated regarding sections 419 and 419A:

> "The conferees emphasize that, in prescribing regulations relating to the definition of a fund, the Treasury Department is to take into account that the principal purpose of the provision is to prevent employers from taking premature deductions for expenses that have not yet been

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conferees reiterate that any regulations defining the term "fund" should take into account that the principal purpose of the provision is to prevent premature deductions by employers."

Under the prior law (pre-1986) an employer's contribution to a VEBA was, with certain limitations, deductible in the year the contribution was made rather than at the time the benefit was provided. The limitations imposed by the prior law were generally determined under I.R.C. § § 162 or 212. I.R.C. § § 263, 446(b), 461(a) and 461(h) provided additional guidelines and limitations as to the timing and amount of deductible contributions. Revenue Rulings 69-382, 69-478, and 73-599 were issued to provide more detail on the operational aspects of the law in this specific area.

Since the establishment in 1986 of the "new" law, (specifically I.R.C. § 419(b)), the amount of an otherwise deductible contribution for any taxable year cannot exceed the VEBA's "qualified cost" for that year. This qualified cost is defined in § 419(c) as being the sum of the fund's "qualified direct cost" plus any allowable "addition to a qualified asset account" for the taxable year in question.

I.R.C. § 419(c)(3) defines "qualified direct cost" as the amount (including administrative expenses) that an employer could deduct had it provided the benefit directly instead of through an intermediary fund. Although I.R.C. § 419 is controlling, the basic requirements of I.R.C. §§ 162 and 212 still must be met in order for a contribution to be considered deductible. These rules are applicable to the employer even though the benefits are provided through the fund and not directly by the employer. Significantly, a benefit is considered as being provided only in the year the benefit is includable in the income of the employee, or would have been includable except for the other Code provisions excluding such a benefit from income.

I.R.C. § 419A(a) defines "qualified asset account" as any account consisting of assets set aside to provide for payment of disability, medical, SUB pay, severance pay or life insurance benefits. I.R.C. § 419A(b) provides an addition to such an account is allowable only to the extent that it does not result in the amount in the account exceeding the account limit for the tax year of the fund. Section 419A(c)(1) defines this account limit as the amount reasonably and actuarially necessary to fund any claims incurred but unpaid as of the close of the fund's tax year as well as any administrative costs associated with such claims.

I.R.C. 419A(c)(5) provides for special limitations where there are no actuarial certifications. These limitations are referred to as "safe harbor" limits. For short-term disability benefits the limit is 17.5% of the qualified direct costs for the immediately preceding taxable year with respect to such benefits. For medical benefits the limit is 35% of the respective costs. The Committee Reports specify that allocable administrative costs associated with such benefits are includable in the determination of the benefit cost basis.

CONCLUSION

In the subject case, it appears that only amounts contributed to the VEBA fund that represent incurred but unpaid costs as of the close of the fund's tax year (inclusive of administrative costs) could be deductible. As to the "safe harbor" amount of $ [redacted] not being includable in income, this amount must first be captured in income (under I.R.C. § 451(a)) before being deducted as a VEBA contribution. Remember, safe harbor amounts are deductible only as substitutions for actuarial determined amounts and are deductible only to the extent that they are representative of costs incurred but not paid by the end of the year.

The question of funding retirees benefits in the VEBA must be addressed. From the previous discussion, it seems clear that the only contributions deductible for purposes of retirees benefits under §§ 419 and 419A, are contributions that represent benefits incurred but not paid. Therefore the actuarial calculation of the present value of retirees benefits at the end of [redacted] and [redacted] incurred but not paid should be deductible. Currently, however there are some theories being offered regarding prefunding an obligation to provide medical benefits to retirees. Because of the complexity of the issue and the lack of precedent, we have forwarded [redacted]'s proposed adjustments with our requests for coordination to our attorney's in CC:EE.

At this time, and contingent upon the information we have been provided with, it is our judgement that Exam's disallowance and resulting proposed adjustments seem reasonable, provided there is an allowance for costs incurred but not paid at the end of the taxable year.